INDUSTRY COMMENT

PRICING WATER IN A COMPETITIVE MARKET

Price will be a critical success factor in the open market. How should suppliers go about setting prices that are commercial, compliant and sustainable?

The competitive market for non-household water services opens in April 2017. While this is 21 months away, retailers who will compete in this market will need time to develop compliant prices they are confident will be attractive and profitable. The estimated £394m plus of water bill savings that retail competition will deliver indicates the scale of the changes in the level of prices. Savings will be driven by a fundamental shift from regulated monopoly prices to doing deals with business customers who will be able switch to other suppliers.

Competition has already started and a number of major water companies including Business Stream, Severn Trent and United Utilities are currently targeting customers so they get off to a flying start.

Taking advantage of the new opportunities to grow market share requires the right approach to pricing but also a cultural revolution which puts meeting customer needs at the centre of a business which is agile, dynamic and sales orientated.

Although there is much to do to prepare for competition, this article is focussed on pricing as a critical success factor. The aim is to identify key factors to analyse when setting prices which are compliant, commercial and create sustainable relationships with customers.

Price discovery

Whilst pricing in utility markets is not rocket science, it is new and novel in the water sector in England and there are important lessons from best practice in water pricing in Scotland and other sectors such as electricity. Broader utility experience provides relevant insights and techniques which can and should be applied in the water sector. Particularly, in the early days of the new market there will be a need for a price discovery process including open engagement between retailers and customers to uncover the products and pricing which customers most value and which are profitable for retailers. There may be a number of initial deals where the pricing is unsustainable as market participants gain experience and reliable pricing norms emerge. After an initial focus on competing on price, I expect that competition will shift more to product innovation and added value.

For the retailer, there is a real benefit from getting the right balance between increasing market share, improving profitability and building sustainable long-term customer relationships. An important requirement for success is to listen carefully to customers, to understand competitors' pricing and to be willing to evolve retail pricing and indeed your business model in the light of market forces. This is part of a free market revealing the preferences of consumers, encouraging innovation and rewarding those who adopt the right approach. Key considerations impacting on commercial pricing decisions are illustrated in Figure 1.

Companies wishing to win new customers and to retain existing customers need convincing and profitable answers to customer questions including what value added is being offered and how much will they charge. These questions are critical whether the company's marketing strategy is:

- A relationship driven approach focussed on particular customers
- Targeting national coverage of all customer types, or
- Initially seeking to defend existing customers

However, the strategy selected will have an impact on the level of costs and pricing.

FIGURE 1: KEY PRICING CONSIDERATIONS

Price components

The retail price of water consists of two building blocks: a regulated wholesale tariff plus a gross retail margin (see Figure 1). Ofwat control the gross retail margin by capping retail revenue per customer by customer type and in addition this margin is subject to competitive pressure which may push it below this cap.

In more detail, price consists of:

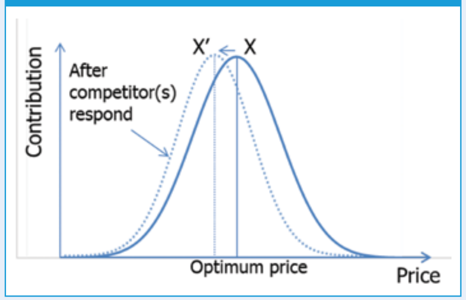
- **Price** = regulated wholesale tariff (the largest cost component) +
- **start-up costs** (significant during the early years of the market) +
- **overheads** (tricky to allocate within a company which is both a wholesaler and a retailer) +
- **variable retail costs** (e.g. commission) +
- **profit margin** (Ofwat have set an overall net retail margin of 2.5% on top of the allowed wholesale and retail costs)

Although there is much to learn from pricing best practice in related markets such as energy, there are a number of unique characteristics of the water market including the low value of the product, the regulatory cap on the net retail margin, and critically a regulated wholesale price that is transparent and is the same for all retailers. Therefore pricing is to recover start-up and overhead costs and to generate the target profit margin.

Competitive forces have a significant impact on the gross retail margin realised. High prices could be counter-productive if they lead to low volumes and hence low total contribution to set-up costs, overheads and profits. While it is clear that the shape of the price contribution curve is an inverted U (see Figure 2) the trick is to locate the optimum point X which maximises the contribution.

An important part of determining the optimum point is exploring the implications of different levels of pricing in a dynamic market. For while one retailer is seeking to determine and achieve this optimum, competitors will adjust their own pricing in search of their own optimum. It is here that multi-player game theory can help retailers to understand how competitors will react and optimise their plans. Thus if an important competitor(s) reduces price / improves the value of its offering then the curve shifts to the left (the dotted curve in Figure 2) and the optimum price falls (X' in Figure 2). The first retailer's pricing decisions should be influenced by how he thinks competitors will respond in a dynamic game.

FIGURE 2: CONTRIBUTION AND PRICE



Face the competition

Competitors can be categorised as:

- Entrepreneurial entrants
- Incumbents
- Multi-utilities

Each of these competitor types will have their own business model and approach to pricing; and will respond in different ways to changes in market prices and discovery of customer preferences.

In practice, the profitability of the retailers will depend upon how well they select and then execute their strategy as compared to competitors. Thus it is important to understand the policies strengths and weaknesses of competitors some of whom will compete on price and therefore pressure profit margins while others will focus on building market share.

Smaller entrepreneurial entrants will often seek to establish themselves by innovating with the introduction of disruptive new products and business models. New entrants are well positioned to establish a fresh new brand through, for example emphasising quality of service and customer focus. Entrants have an opportunity to leap-frog existing systems and move straight to more agile systems based on modern system architecture which are customer centric, and support rapid and accurate pricing so that profitable but discounted deals can be struck quickly.

Incumbents have the advantages of existing staff, systems and relationships but they also carry baggage in terms of culture, image and decision making processes which grew out of a regulated market and are not optimised for the cut and thrust of a dynamic, competitive market in which all business customers can switch supplier.

Experience in Scotland indicates that as the regulated wholesale price is the same for all retailers, competition will focus on quality of service, product design as well as the gross retail margin. While the basic services of water supply and sewerage disposal are reasonably standardised there remains opportunities to discount, package services in new ways and to provide value added services such as online monitoring, water efficiency and aggregated billing. This will be a key area in the battle for customers.

The third competitor, multi-utilities, will be seeking to provide bundled services including water and sewerage. The prospect of cost savings, increased market share, and other competitive advantages is prompting more and more utilities to cross traditional industry lines and offer services in several sectors. A number of energy companies are contemplating entering the water market and offering a bundle of services which spread customer relationship costs including billing over a number of services and make customers stickier. These multi-utility offers typically include discounts for customers who buy more than one product, e.g. water and energy.

Regulatory considerations

Ofwat is keen that the market is transparent and avoids unnecessary complexity for a number of reasons including encouraging entry into the market and competitive rivalry. Ofwat is making it easier to offer simple pricing across a number of water supply areas and for customers to compare prices and so have the confidence to actively participate in the market. Sensible standardisation of charges, especially for items generating limited revenue such as swimming pools, and pricing transparency will support the development of a successful vibrant market.

As part of consumer protection, Ofwat and Defra are also concerned about incidence effects and how they are managed. This important agenda is at the heart of creating a market which consumers trust and which clearly serves their needs. Incidence effects are where price changes cause customers to face bill increases significantly out of line with overall price changes. Where companies make significant changes to their tariffs, Ofwat requires that they carry out a proportionate impact assessment and develop a strategy for handling any resulting incidence effects.

Water companies also need to be aware of competition law and the requirement that there is no anti-competitive pricing. Competition authorities will particularly be looking for retail businesses having privileged access to information from a related water wholesaler.

The price is right

While no retailer likes to lose customers this is a normal part of a competitive market and will happen even with the optimum pricing strategy. Some customer churn is to be expected and should not be a cause for concern unless there is a significant net loss of customers or there is an unwanted negative trend in customer numbers or profitability. However, for a solely "in area retail business" which will start with 100% market share their customer numbers can only go down.

To be successful companies will have, among other things, to get their pricing right. This will be a key area of focus at market opening, and thoughtful analysis, focus on customers and agility will be required to come out on top. However, even when the market starts to settle down there will need to be continuing focus on prices to respond to customers and competitors. TWR

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